Free Lunch Illusion

How could so many smart people fall for the fantasy?

By Kenneth S. Rogoff

With forward-looking measures of long-term real interest rates soaring, markets have suddenly become much less forgiving of undisciplined, open-ended spending increases and tax cuts, not just for emerging market governments, but for advanced economies as well. Has the free lunch era of fiscal policy, if there really ever was one, come to an end?

My recent research with econometrician Barbara Rossi and economic historian Paul Schmelzing suggests that if one takes a long enough view of things (seven centuries, but a couple will do), it becomes clear that there is a distinct tendency for sharp changes in real interest rates (nominal interest rate adjusted for expected future inflation) to ultimately revert to trend. If so, the implication is that even after central banks are done with the current rate hiking cycle, and looking past any subsequent recession, one should not necessarily expect nominal ten-year rates to settle at the levels the world had become accustomed to after the global financial crisis. Instead, they might average something closer to the early years of the twenty-first century.

Real interest rates after the global financial crisis fell off a cliff. Measured by the yield on a ten-year inflation-indexed U.S. Treasury bond, the real interest rate fell from an average of around 2 percent 2003–2007 to around zero percent 2012–2021, with a drop of over 3.5 percent from peak to trough. It was a good ride while it lasted. Ultra-low real interest rates were a central driving force behind the massive run-up in the price of virtually every long-lived asset, from equities to housing to art to Bitcoin.

They also played a central role in the debate over fiscal policy, for example in Olivier Blanchard's celebrated (2019) argument that governments had scope

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to raise spending without ever raising taxes directly or—importantly—through unanticipated inflation; that is, there could be a free lunch. The belief that low real rates would be around forever was equally central to debates about how to recalibrate monetary policy to deal with the zero bound on nominal interest rates, and played an important part in the U.S. Federal Reserve’s August 2020 change in its monetary framework.

After central banks are done, interest rates might average something closer to the early years of the twenty-first century.

When former Treasury Secretary and Director of the National Economic Council Larry Summers gave his famous 2013 “secular stagnation” speech, a central thesis was that real interest rates had been falling secularly throughout the twenty-first century even after the disinflation of the 1980s and 1990s had ended. Moreover, fundamentals such as slow growth and demographic decline could be expected to keep rates low indefinitely. Over time, much of the economic profession came around to this view. Shortly after stepping down from his position as chair of the Federal Reserve in 2014, Ben Bernanke was telling private audiences that he did not expect to see a 4 percent average federal funds rate again in his lifetime. Given that he was only sixty years old at the time, and that the original 1992 “Taylor rule” posited 4 percent as the normal average fed funds rate (2 percent real interest rate and a 2 percent inflation rate), this was quite a statement. But it more or less reflected the consensus among economists at the time.

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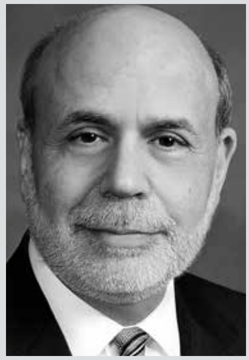

The idea that interest rates would remain lower forever became deeply embedded in politics on both sides of the aisle, whether it was Republicans who believed that taxes could be sharply cut without reducing spending, or Democrats who believed that spending could be massively raised without raising taxes. Whoever was in power was keen to order the free lunch of their choosing. The same was true throughout the world. In Europe, including the United Kingdom, the prominent view was that fiscal policy should be maximalist, and anything short of that was “austerity.”

Perhaps surprisingly, a large academic literature supported the “lower forever” view of interest rates. First, a long empirical literature seemed to show that real interest rates have a significant “random walk” component, meaning statistically that after the sharp drop, there was no presumption of reversion to mean. (My work with Rossi and Schmelzing suggests that might have been the result of relying too much on relatively short time periods, and perhaps focusing too much on very short-term policy rates which are buffeted

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Bipartisan Illusion

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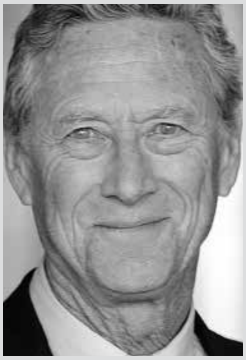

Interest rates played a central role in the debate over fiscal policy, for example in **Olivier Blanchard's** *celebrated (2019) argument that governments had scope to raise spending without ever raising taxes directly or—importantly—through unanticipated inflation; that is, there could be a free lunch.*

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by many liquidity and cyclical factors.) Second, a cottage industry of research developed, much of it published in top journals, arguing that long-term factors such as fading demographics, weak trend growth, and rising inequality had been responsible for pushing rates down and would likely persist. These arguments also become much less convincing when one tests them with very long-term data.

For years, when some of us argued that the possible end to the ultra-low-rate era needed to be considered in formulating debt management policy—including not only the level but the maturity structure of debt—the argument was dismissed. After all, the only thing that could sharply raise real interest rates was a sharp rise in global growth, so that higher tax revenues could cover any added interest rate costs, right? That logic does not seem to be working so well right now.

Why might higher real rates persist even after the current cycle ends in perhaps a couple of years? I do not have a definitive answer, but clearly there are many factors pointing in that direction. The massive rise in global debt (public and private) has likely been more than sufficient to move the needle. It is also clear that there are enormous pressures to raise defense spending, on top of the costs of the green transition. With the war in Ukraine, and China's bellicose threats to Taiwan, geopolitical risk has increased. At the same time, the rise in populism across the world has made it difficult for politicians to explain that sometimes painful choices need to be made.

If one looks at long enough time periods, inheriting extremely high debt weighs on average long-term growth.

Debt finance is a powerful tool in recessions and for dealing with catastrophes and wars. It can be used to finance productive long-term investments. Countries that have a strong fiscal balance sheet can and should take advantage of it as needed. But it is not a free lunch, and when debt becomes very high, it can constrain governments, particularly when global interest rates are at normal, or elevated, levels. As the academic literature generally finds, if one looks at long enough time periods, inheriting extremely high debt weighs on average long-term growth.

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Lastly, it is important to note that there is a very gentle downward trend in real interest rates when one looks at century-long time periods, perhaps 1–2 basis points per year, again as shown in my work with Rossi and Schmelzing. But this slight trend is microscopic compared to the drop in rates after the financial crisis, most of which will likely dissipate over the medium term, at least averaged across normal business cycles.

In our 2009 book *This Time Is Different,* Carmen Reinhart and I discuss the recurrent tendency of investors and policymakers to seek rationalizations for why current favorable trends are likely to last forever. Time will tell, but the long-dominant view that ultra-low post-financial crisis real interest rates were caused by secular factors that would persist indefinitely, and that policy could be calibrated accordingly, seems likely a new addition to a long list. ◆